INTERNATIONAL MONETARY FUND

Safeguards Assessments—Review of Experience

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In consultation with other Departments

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Contents Page

Tables

Boxes

Annex

Acronyms

AfDB	African Development Bank
ADB	Asian Development Bank
DQAF	Data Quality Assessment Framework
ECB	European Central Bank
ELRIC	The framework used by the Fund to conduct safeguards assessments at member central banks. ELRIC stands for (i) the **E**xternal audit mechanism; (ii) the **L**egal structure and independence of the central bank; (iii) the financial **R**eporting framework; (iv) the **I**nternal audit mechanism; and (v) the internal **C**ontrols system.
EPCA	Emergency Post-Conflict Assistance
FIN	Finance Department of the IMF
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
NDA	Net Domestic Assets
NIR	Net International Reserves
OIA	Office of Internal Audit and Inspection of the IMF
STA	Statistics Department of the IMF
TA	Technical Assistance
TMU	Technical Memorandum of Understanding

EXECUTIVE SUMMARY

The safeguards assessments policy was introduced in March 2000 to provide reasonable assurance that central banks have adequate financial control systems in place to manage their resources and Fund disbursements. The safeguards policy's main objective is to minimize the possibility of misreporting or misuse of Fund resources associated with the Fund's lending activities. Safeguards assessments apply to all member countries that have a Fund arrangement.

Safeguards assessments involve an evaluation of central banks' operations in five areas: the external audit mechanism, the legal structure and independence, the financial reporting framework, the internal audit mechanism, and the system of internal controls. The assessments result in formulation of recommendations, with an associated timeframe, to address any identified vulnerabilities. Recommendations are included in program conditionality when considered necessary. Implementation of safeguards recommendations is monitored by staff through periodic communication with the central banks.

Recent experience shows that the policy has had a positive impact on central banks' own operations, and in particular, that there have been considerable improvements in controls at the central banks; this view is shared by the panel. Central banks demonstrate a heightened awareness of the importance of proper audits, adherence to high-quality accounting standards, and appropriate control and oversight functions. In addition, the policy has helped focus central banks on the quality and robustness of data provided under Fund-supported programs.

The policy is not a panacea; for example, while the assessments have led to a strengthening of controls related to program data reported to the Fund, the policy cannot prevent misuse of resources that may occur as a result of a willful override of controls or manipulation of data. Moreover, the policy does not cover fiscal data since safeguards assessments focus on central banks.

Based on experience over the past five years, the framework used to conduct safeguards assessments has proven to be broadly appropriate. Reference benchmarks have generally been interpreted flexibly and country specific circumstances have been taken into account where possible. At the same time, on occasion there have been obstacles in the implementation of safeguards recommendations due to specific legal restrictions in some countries, capacity constraints at the central banks, or, in a few cases, political sensitivities. Acceptable compromises, without undermining the policy's objectives, were agreed in most instances.

Going forward, staff expects a shift in the focus of safeguards assessments to the monitoring of previously assessed central bank frameworks. The nature of future safeguards assessments will evolve toward more focused and targeted follow-up assessments. This paper proposes that safeguards assessments under Emergency Post-Conflict Assistance

(EPCA) cases be undertaken on a case-by-case basis with the scope of the assessment reflecting the degree of re-establishment of a fully functioning central bank.

In its 2002 discussion during the first review of the safeguards policy, the Board asked that an independent panel should be involved in the next review of the policy. A separate report prepared by an independent panel is being circulated for concurrent consideration by the Board. The panel's report concludes that "*the safeguards policy has been highly successful in achieving its objectives*." The panel also observed the need to strengthen communication between the Fund and central banks on safeguards issues and to broaden monitoring procedures for central banks previously subject to an assessment. The staff concurs with the recommendations of the panel. Furthermore, efforts will be made to broaden available channels of information and communication on the safeguards policy as recommended by the panel.

Issues for Board consideration are set out in Section V.

I. INTRODUCTION

1. **This paper reports on the experience of the safeguards assessment policy since March 2000, when the policy was first established**. The policy was the response to indications in the late 1990s of increased risk of misreporting and misuse of Fund resources associated with the Fund's lending activities. In March 2002 the Executive Board approved the safeguards policy as a permanent feature of Fund operations and also agreed that the policy should be reviewed within three years.[1]

2. **As part of this review, an independent panel of central bank officials conducted a separate appraisal of the safeguards process**. As background for its appraisal, the panel solicited feedback from central banks that have undergone a safeguards assessment. The panel's report is concurrently being circulated to the Board with this paper and includes the panel's composition and terms of reference.[2]

3. **This paper is organized as follows**: Section II discusses the policy's objectives, results and observations from safeguards assessments conducted to date. Section III discusses operational aspects of the safeguards policy. Section IV contains a forward looking discussion of the application of the safeguards policy and its modalities, and also summarizes and addresses the panel's main observations. Section V outlines the issues for Board consideration.

II. HAS THE POLICY ACHIEVED ITS OBJECTIVES?

A. Objectives of the Safeguards Policy

4. **The overarching objective of the safeguards policy is to protect the Fund's resources** through a fiduciary assessment of financial safeguards at central banks. Safeguards assessments aim to provide reasonable assurance that central banks have adequate control, accounting, reporting and auditing systems in place to manage their resources, including Fund disbursements. As noted by Directors in the Board's March 2000 discussion on the safeguards policy, "*reliable information is essential to every aspect of the Fund's work—surveillance, financing, and technical assistance—and is particularly important in ensuring that the Fund's resources are used for their intended purposes*."[3]

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[1] See *Summing Up on Safeguards Assessments,* (4/1/02); *Safeguards Assessments—Review of Experience and Next Steps*, (2/19/02); and *Safeguards Assessments—Review of Experience and Next Steps—Independent Review of the Safeguards Assessments Framework*, (2/19/02).

[2] See Report of the Independent Panel on Safeguards Assessments, (4/1/05).

[3] See the first paragraph in the Summing Up on Strengthening Safeguards on the Use of Fund Resources, (3/30/00).

B. The Safeguards Process

5. **Safeguards assessments are an integral part of the Fund's lending activities and apply to all member countries with an arrangement from the Fund**. Safeguards assessments focus on central banks and are a diagnostic exercise, carried out by Fund staff, to evaluate certain key operations of a central bank. The outcome of a safeguards assessment is a report that includes recommendations to mitigate any identified vulnerabilities in the central bank's operations. Where considered necessary, safeguards assessment recommendations may become part of program conditionality.

6. **Safeguards assessments consider the adequacy of five key areas of control and governance within a central bank**, which are denoted by the acronym *ELRIC* representing: (i) the ***E***xternal audit mechanism, (ii) the ***L***egal structure and independence, (iii) the financial ***R***eporting framework, (iv) the ***I***nternal audit mechanism, and (v) the system of internal ***C***ontrols (see Box 1 for a more detailed description of each area).

7. **The assessments are conducted independently from other Fund activities such as Fund surveillance, program negotiation, and technical assistance activities**. Safeguards assessments are a form of due diligence in the Fund's lending operations and are thus distinct from other Fund initiatives that aim to enhance transparency and data integrity, such as Financial Sector Assessment Programs (FSAPs), Reports on the Observance of Standards and Codes (ROSCs), and participation in data dissemination standards. In addition, these initiatives are *voluntary* while the safeguards policy is linked to Fund lending.

8. **Safeguards assessments apply to all new Fund arrangements**, including augmentations to existing arrangements.[4] In its discussion on instruments and financing for low-income member countries in March 2004, the Board discussed the extension of the safeguards policy to cover members making use of Emergency Post-Conflict Assistance (EPCA).[5] Possible modalities are discussed in Section IV.

9. **Safeguards assessments are based on a review of documents, and discussions with the authorities and the central bank's external auditors**. All central banks subject to a safeguards assessment are required to provide an initial set of documents on the above five areas of control and governance within the central bank. The documents are reviewed by Fund staff in Washington D.C. (the *off-site* part of the assessment). The review is usually supplemented by an *on-site* visit to the central bank to obtain or clarify information necessary to draw conclusions and complete the safeguards assessment report, including

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[4] Assessments also apply to Rights Accumulation Programs, but they do not apply to first credit tranche purchases, stand-alone Compensatory Financing Facility (CFF) purchases, or to Staff Monitored Programs (SMP) although countries implementing an SMP are encouraged to voluntarily undergo an assessment.

[5] *The Fund's Support of Low-Income Member Countries—Considerations on Instruments and Financing* (2/24/04).

Box 1. The Safeguards Framework

The five key areas of the safeguards *ELRIC* framework, which are evaluated during an assessment are:

The External Audit Mechanism. The external audit mechanism comprises the practices and procedures in place to enable an independent auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an established financial reporting framework. An external audit mechanism is important for the credibility of a central bank; the objective of the assessment is to establish whether an independent and high-quality external audit of the central bank's financial statements is conducted regularly and whether previous recommendations made by the auditors have been implemented.

The Legal Structure and Independence. Government interference with central bank operations can undermine a central bank's autonomy and increase the risks to which it is exposed, particularly if agencies other than the central bank have responsibility for reserves management. The objective in assessing this area is to ensure that (i) the arrangements whereby the central bank extends credits, advances or overdrafts to the government follow legal procedures, and that the government has not interfered with these regulations; and (ii) for those agencies that share monetary authority with the central bank, the legal basis of their relationship to the central bank, their role as a monetary authority, and the responsibility for reserves management are transparent and explicit.

The Financial Reporting. Adequate financial reporting practices are an essential element of effective central bank operations and encompass the provision of both internal information (including financial, operational and compliance data) and external market information about events and conditions that support decision-making. For such information to be useful it must be relevant, reliable, timely, accessible and provided in a consistent format. The objective in assessing financial reporting practices is to ensure that the central bank adheres to international good practices in its accounting principles, financial statement presentation and disclosures, coverage of operations, and reporting of statistical data. Non-adherence to accepted good practices might be an indicator of a lack of transparency and accountability.

The Internal Audit Mechanism. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic approach to evaluating and improving the effectiveness of its risk management, control, and governance processes. The objective in assessing the internal audit function is to evaluate its effectiveness by considering the organizational independence and objectivity that allows the internal audit activity to fulfill the nature and scope of its work program and the procedures for communicating results unencumbered from external interference.

System of Internal Controls. Internal control is a process comprising all the policies and procedures effected by the board, management, and other personnel of a central bank to assist in achieving (i) the effective and efficient conduct of its business, (ii) its compliance with applicable laws, regulations, policies, plans and internal rules and procedures, and (iii) the timely preparation of reliable financial information. A system of effective internal controls is a critical component for the sound operation of central bank activities, including the safeguarding of assets, the prevention and detection of fraud and error, and the accuracy and completeness of accounting records. The objective in assessing internal control systems is to determine whether appropriate procedures are in place, at all levels, to provide reasonable assurance that material risks that could adversely affect the central bank's operations are being continuously recognized, assessed, and mitigated. The main focus is on controls over the banking, accounting and foreign exchange operations of the bank.

recommendations to address any identified risks in the bank's operations. Country authorities have the opportunity to comment on the safeguards assessment report before the report is finalized and submitted for approval by Fund management. After approval of the report, Fund staff conducts *off-site* monitoring of the implementation of recommendations through periodic communications with the central bank on the status of remedial measures. Such on-going monitoring is conducted for as long as Fund credit is outstanding, including review of the central bank's annual financial statements and reports by the external auditors on internal controls at the central banks.

10. **Safeguards assessment reports are confidential documents** transmitted to the central bank and the relevant Fund Executive Director. The Executive Board receives a summary of the findings and recommendations of a safeguards assessment in staff reports and periodic update reports on safeguards assessments in general. Central banks are subject to update assessments if a member country requests a subsequent new, or successor, Fund arrangement.

C. Results and Impact to Date

11. **Since inception of the safeguards policy, staff has completed 111 safeguards assessments** (see Annex I). These assessments cover 69 central banks; some central banks have been subject to both a transitional[6] and full assessment, or have had two or more assessments as a result of subsequent new Fund arrangements or augmentations.

12. **Safeguards assessments have generally been welcomed by central banks and the policy has yielded positive results overall**. For the purposes of this paper, the general results of the policy are evaluated in four broad categories, as follows: (i) the impact on central banks' operations and governance structures; (ii) enhanced awareness of the quality and reliability of data provided to the Fund; (iii) misreporting cases; and (iv) possible misuse of Fund resources.

13. **The safeguards recommendations have strengthened the control frameworks in the central banks**. Recommendations have generally been implemented (see Table 1). When serious vulnerabilities were identified in a central bank's governance and control framework, recommendations were part of program conditionality. Such high-priority safeguards recommendations were used judiciously and within the framework of conditionality guidelines, and represented ten percent of total safeguards recommendations (57 out of 569 total recommendations as shown in Table 1).

[6] When the safeguards policy was introduced, it was decided that members with a Fund arrangement in place as at June 30, 2000 would be subject to a *transitional assessment* of only the central bank's external audit function. Full safeguards assessments cover all five safeguards *ELRIC* areas.

Table 1. Implementation Rate of Safeguards Recommendations 1/
(as of March 1, 2005)

	Number	Implementation Rate (*Percent*)
1. Recommendations with formal commitment from the authorities	124	*96.8*
a. Under program conditionality 2/	57	
of which: Implemented	*55*	*96.5*
b. LOI/MEFP commitments	67	
of which: Implemented	*65*	*97.0*
2. Recommendations not under program conditionality or LOI/MEFP commitments	445	
of which: Implemented	*339*	*76.2*
3. Total recommendations (1+2)	569	80.7

1/ Includes recommendations in all 111 safeguards assessments, except for recommendations where the suggested implementation date is later than March 1, 2005 and recommendations which are not monitored, i.e., recommendations that have been superceded or cases where subsequent to the assessment, there was no arrangement.

2/ Includes 11 prior actions (all implemented), 14 structural performance criteria (13 implemented), and 32 structural benchmarks (31 implemented) as conditionality in the program design for a total of 27 countries.

Impact on Central Banks

14. **The policy has helped identify areas in central banks' operations that needed strengthening**. The main findings of safeguards assessments are summarized in Table 2. Key deficiencies that were identified included the absence of external audits, or audits that did not meet International Standards on Auditing (ISA); poor transparency practices with regard to publication of financial statements; inadequate control procedures over foreign reserves especially with regard to the data compilation processes and valuation methodology; and inadequate accounting practices that did not meet the requirements of International Financial Reporting Standards (IFRS). Steps taken by central banks to address these deficiencies have led to improvements in many cases. This is also evidenced by the general acceptance of the findings and implementation of recommendations by central banks. The panel shares this view and noted in its report that safeguards assessments have helped improve control systems at central banks (paragraph 3 in the panel's report).

15. **Safeguards assessments in recent years have shown that central banks have made considerable improvements in controls in many cases**. Central banks have strengthened external audit mechanisms, controls over foreign reserves, accounting standards and internal audit functions. Table 2 indicates fewer key weaknesses identified from 2003

Table 2. Main Findings of Safeguards Assessments
(as of March 1, 2005)

	2000–2002		2003–present	
	Number of Assessments 1/	Percent of Total 2/	Number of Assessments	Percent of Total
1. Non-existent or deficient external audit 1/	34	52	11	24
2. No or delayed publication of financial statements 1/	25	38	20	43
3. Inadequate controls over foreign reserves	18	47	15	33
4. Inadequate financial reporting standards	30	79	24	52
5. Deficient governance oversight	26	68	23	50
6. Deficient internal audit	29	76	26	57
7. Inadequate governing legislation	16	42	17	37
8. Inadequate accounting for Fund transactions	9	24	8	17
Memorandum items:				
Total number of assessments completed 3/	65		46	
Of which:				
Transitional assessments 1/	27			

1/ Countries with a Fund arrangement as at June 30, 2000 were subject to a "transitional assessment" of only the central bank's external audit function (including publication of audited financial statements). Full assessments covered all five ELRIC areas. During 2000–2002, 15 transitional assessments identified a non-existent or deficient external audit mechanism and 10 noted issues with respect to the publication of financial statements.
2/ For the first two findings the percentage represents all assessments (65 assessments including the 27 transitional assessments) completed during the period. For the other findings the percentage represents only full assessments (38).
3/ As of March 1, 2005, 111 safeguards assessments were completed, covering a total of 69 central banks. Several central banks have been subject to multiple assessments.

onwards compared to the 2000–2002 period; the publication of financial statements is one area that is an exception to this trend, but 19 central banks that previously did not, have now started to publish their full annual financial statements. Staff has found a heightened awareness among central banks of the importance of proper external audits, the adherence to an established set of accounting standards, and the control and oversight functions performed by internal audit staff and audit committees.[7] Recent high-profile governance failures in the private sector may also have been a contributing factor.

16. **Central banks have implemented key recommendations in all safeguards areas**. As detailed in Table 3, international audit firms have been appointed as external auditors at 18 central banks; an internationally recognized financial reporting framework has been introduced at 16 central banks; and data reconciliations of key monetary program data with the underlying accounting records have been performed at 34 central banks for the first time. In addition, transparency has improved through first time publication of full financial statements at 19 central banks; internal audit charters, or the internal audit function itself, have been developed with direct internal audit reporting lines to senior levels at 19 central banks; and 15 central banks have established a new audit committee or supervisory board.

Enhanced Awareness of Data Integrity Issues

17. **The safeguards policy has led to more attention, by both central banks and Fund staff, to the quality and robustness of data provided under new programs**. An important element in all safeguards assessments is the evaluation of controls in the procedures for compiling a subset of critical monetary data that are reported to the Fund, specifically, net international reserves (NIR) and net domestic assets (NDA), including their consistency with agreed terms in the Technical Memorandum of Understanding (TMU). Steps taken by central banks to improve the reliability and robustness of the data have included establishment of independent oversight roles undertaken by external auditors and audit committees. In addition, the timeliness of reporting and collaboration among departments at the central bank have been strengthened at many central banks.

18. **In a number of cases, safeguards assessments have led to strengthening of controls related to program data reported to the Fund**. Specific examples of improved practices are as follows:

- Anomalies were identified in the program data provided to the Fund with respect to some restricted assets that were included as part of NIR by one country. Periodic reconciliations with the accounting records were established for key monetary data reported to the Fund, with reviews conducted by the internal audit department of the central bank to ensure conformity of these data with program requirements. Further, the restricted assets were excluded from subsequent NIR data reported to the Fund.

[7] Fund staff has also been organizing safeguards assessment seminars to explain the safeguards process and the importance of the framework for central banks. To date, six one-week seminars have been conducted through the IMF Institute (INS) and regional training centers. More than 170 central bank officials from 92 countries have attended these seminars.

Table 3. Key Safeguards Recommendations Implemented by Central Banks

Measure	Implemented by:
1. First time appointment of an international auditor. (18 central banks)	Bangladesh, Burundi, Colombia, Djibouti, Ecuador, Ghana, Guatemala, Honduras, Lesotho, Macedonia (FYR), Nepal, Peru, Romania, Rwanda, Sri Lanka, Tanzania, Turkey, and Uruguay.
2. First time reconciliation of key program data with accounting records. (34 central banks)	Albania, Argentina, Azerbaijan, Bangladesh, Bolivia, Cape Verde, Colombia, Democratic Republic of Congo, Dominican Republic, Georgia, Ghana, Guyana, Honduras, Jordan, Kenya, Latvia, Lao P.D.R., Macedonia (FYR), Malawi, Moldova, Mongolia, Nepal, Nicaragua, Pakistan, Paraguay, Romania, Rwanda, Serbia & Montenegro, Sierra Leone, Sri Lanka, Tajikistan, Tanzania, Turkey, and Uganda.
3. First time publication of full audited financial statements. (19 central banks)	Argentina, Bangladesh, BCEAO, Democratic Republic of Congo, ECCB, Ecuador, El Salvador, Ethiopia, Honduras, Indonesia, Macedonia (FYR), Mongolia, Paraguay, Romania, Rwanda, Serbia & Montenegro, Sri Lanka, Tanzania, and Turkey.
4. Internationally recognized financial reporting framework introduced. (16 central banks)	Bangladesh, Bolivia, Ghana, Guinea, Jordan, Kenya, Latvia, Lesotho, Macedonia (FYR), Malawi, Mongolia, Pakistan, Peru, Romania, Sri Lanka, and Turkey.
5. Internal audit: (i) New internal audit function established. (2 central banks)	Cape Verde and Turkey.
(ii) New reporting line to the central bank governor or the board established. (3 central banks)	Bangladesh, Guatemala, and Romania.
(iii) Audit charter adopted. (14 central banks)	Albania, Bangladesh, BCEAO, Bulgaria, Guyana, Kenya, Lesotho, Mauritania, Nepal, Rwanda, Sri Lanka, Tanzania, Turkey, and Uruguay.
6. Establishment of a new audit committee or supervisory board. (15 central banks)	Bangladesh, Democratic Republic of Congo, Ecuador, Georgia, Guinea, Honduras, Kenya, Madagascar, Mongolia, Pakistan, Romania, Serbia & Montenegro, Sri Lanka, Uruguay, and Uganda.

- In another case, in addition to weaknesses identified in the processes for compiling and reporting monetary data, NIR data were found to include earmarked amounts for specific imports. Based on the definitions in the TMU, such earmarked amounts should have been excluded from the NIR data. The program data have since been adjusted. Steps are also being taken at the central bank, with technical assistance from the Fund, to establish formal and improved procedures for reporting monetary data.

- In two other cases, foreign treasury instruments were valued at historical cost rather than market value. One central bank has since adopted IFRS, while the other is in the process of adopting full IFRS and has appointed an international audit firm with experience in IFRS. Both banks have instituted periodic reconciliations of monetary program data (NIR and NDA) with the accounting records.

- In one case, Fund disbursements were to be paid to a central bank for direct credit to the treasury, which was also the fiscal agent for the country. As a result, the NIR target under the program was defined on a consolidated basis (i.e., central bank and treasury data combined). The safeguards assessment noted that treasury operations pertaining to foreign denominated short-term debt, a component of NIR, were not subject to the same rigorous audit controls as those at the central bank. Periodic audits have since been commissioned by the treasury.

19. **In yet another case, the safeguards assessment revealed significant data issues**. The assessment found that the external auditor of the central bank was only able to obtain third-party confirmations for about 15 percent of the bank's end-2002 foreign reserves. In addition, the auditor issued a qualified audit opinion with regard to currency in circulation. The assessment concluded that there was considerable risk of misreporting and misuse of Fund resources and recommended, *inter alia*, a special audit of the central bank's foreign reserves at end-2003, prior to completion of the first review of the program. However, (i) the first review was delayed and ultimately never completed, and (ii) official foreign reserves previously reported to the staff as at end-2003 were subsequently revised downward by close to 50 percent.

Misreporting Cases

20. **There have been three misreporting cases of monetary program data since introduction of the safeguards policy** (Ghana, The Gambia, and Vietnam).[8] The safeguards assessment played a key role in helping to detect the misreporting in the case of The Gambia (see Box 2). Misreporting in Ghana and Vietnam occurred prior to the respective safeguards assessments, but the subsequent assessments identified vulnerabilities that may have contributed to the misreporting.[9]

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[8] See reports on noncomplying disbursements: Ghana (1/22/02), The Gambia (2/23/04), and Vietnam (6/7/02).

[9] A 2001 transitional assessment of the Bank of Ghana concluded that although the bank was audited by two local audit firms, there were serious concerns about the quality of the audit and the auditors' qualifications and independence from the BoG; an international audit firm was subsequently appointed. The safeguards assessment of the State Bank of Vietnam, which was initiated in 2001 but not completed despite extensive consultations with the authorities, found that the external audit of the bank's financial statements was not in accordance with ISA.

Box 2. Misreporting and the Safeguards Policy

The Central Bank of The Gambia (CBG) was subject to a safeguards assessment with respect to the PRGF arrangement approved in July 2002. The on-site assessment conducted in March 2003 was not concluded because the 2001 and 2002 financial statements were not yet finalized. The first review of the program was delayed pending, inter alia, provision of the financial statements in order to complete the safeguards assessment. In October 2003, the authorities provided revised program data and financial statements. A second on-site assessment was conducted in November 2003; it confirmed serious governance issues at the CBG, a lack of independence of the external auditor, and inadequate internal controls. Remedial measures undertaken by the CBG include a change in external auditor, a review of internal controls, reaudits of the 2001 and 2002 financial statements and a special audit of foreign reserves. Two noncomplying disbursements made in July and December 2001 have since been repaid.

Misuse of Fund Resources

21. **The safeguards policy cannot prevent misuse of resources that may occur as a result of a willful override of controls or manipulation of data**. Moreover, the safeguards policy focuses on the operations of the central bank and does not cover fiscal activities of the government where misuse can take place. Given these constraints, it is clear that the policy is not a panacea, and this was recognized during the Board's discussion in the 2002 review of the safeguards policy. Moreover, the policy was established as an *ex ante* mechanism and is therefore preemptive in nature.

22. **Notwithstanding the above, several qualitative factors are relevant to assess the safeguards policy's effect on potential misuse of resources**. First, there is a deterrent effect on central banks because of the outside scrutiny. Second, in the course of safeguards assessments, fraud allegations have surfaced revealing the existence of unusual activities at two central banks. Senior management at these banks has been replaced and steps being taken to strengthen controls should reduce the possibility of future misuse of resources. Third, additional control and oversight processes have been established at many central banks as a result of the policy (see Table 3). The new processes include increased transparency through publication of the audited financial statements and establishment of independent bodies such as an audit committee or a supervisory board to oversee operations.

D. Overall Evaluation

23. **The safeguards policy has had a positive impact on the central banks' governance and control frameworks**. The high implementation rates of safeguards recommendations suggest a broad acceptance of the assessments' usefulness, which has been reinforced by feedback during the safeguards process itself as well as by the panel. The effectiveness of the policy with regard to misuse of Fund resources is unknown, but there has been a positive effect on the quality of data reported to the Fund.

III. Operational Aspects of the Safeguards Policy

A. Scope of the Policy

24. **The policy is focused on central banks and, therefore, does not cover fiscal data**. The policy focuses on central banks because, typically, they are the recipients of disbursements under Fund arrangements.[10] The limitation of the policy with regard to fiscal data was accepted by the Board at the introduction of the policy and during the 2002 review. Staff does not propose an extension of the assessments to the fiscal area for the same reasons as raised in 2002.[11] In this regard, it is also important to recognize developments in recent years with regard to fiscal data quality (see Box 3).

B. Application of the Policy

25. **Based on experience over the past five years, the ELRIC framework has proven broadly appropriate for assessing central bank operations**. The policy for uniformity of treatment across the membership has worked well and it has been critical to the general acceptance of the policy in demonstrating to country authorities that the policy is *mandatory* for all users of Fund resources.

26. **Flexibility in the application of the policy has been exercised in several areas in recognition of country specific circumstances**. Key examples are: the European Central Bank (ECB) accounting guidelines have been recognized as an acceptable alternative accounting framework to IFRS in a number of cases; and the establishment of an audit committee has not been recommended in specific instances where the board of the central bank, with adequate elements of independence of board members from the decision makers, exercises close oversight of the central banks' operations.

27. **The quality of the external auditor has been a difficult issue in a number of assessments**. External audit mechanisms are judged on their merits, with the independence of the auditor and the quality of the audit (compliance with International Standards on

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[10] For the majority of Fund member countries, the central bank is both the depository and the fiscal agent of the member to the Fund. Of the 184 IMF members, there are 41 countries for which the fiscal agent is the ministry of finance or an equivalent government agency. Although in such cases, Fund disbursements could be made directly to the fiscal agent, such occurrence is very rare—the last such instances were a purchase by the Russian Federation in 1993, and the arrangements with Turkey.

[11] The key reasons were: (i) there are significant informational obstacles in the government sector for most countries with regard to the quality of, and delays in finalizing, government accounts—there would, therefore, be considerable difficulty in adopting a uniform approach given the wide dispersion of practices in this area; (ii) the assessments would need to extend beyond the central government to the activities of state enterprises and lower tiers of government in order to fully capture and assess government expenditure; and (iii) short of assessing all major players in the government sector with regard to extension of assessments, there would be considerable difficulty in determining where to draw the line. In 2002, most Directors agreed that safeguards assessments should not be applied to fiscal issues and other public agencies, since that would require a new mandate for the staff.

Auditing—ISA) being the two main criteria. While there is no *prima facie* case for excluding state auditors, in all but one case, state auditors have not met the minimum safeguards requirements and a variety of remedies, such as joint-audits with a more experienced audit firm, have been proposed (the state auditor was the auditor of the central bank in 14 assessments). At the same time, private audit firms, including local affiliates of large

Box 3. Developments in Fiscal Data Quality

In recent years, the Fund enhanced its activities on improving the fiscal data quality of member countries. Reports on the Observance of Standards and Codes (ROSCs) were developed in response to the financial crises of the late 1990s and the methodology and format of the fiscal and data modules of ROSCs have been refined over time. As of December 31, 2004, 73 fiscal and 51 data ROSCs had been completed.

Fiscal ROSCs
Fiscal ROSCs examine the clarity of fiscal management frameworks, including aspects such as publication of fiscal data, relations between different levels and branches of government, and transparency and accountability of fiscal activities conducted outside the budget. A 2003 review of progress in this area noted that fiscal ROSCs provide a means for systematizing fiscal management information of significance to Fund surveillance, program countries and TA activities.[1] Specifically, (i) Article IV consultations have identified issues in the fiscal area that have led to follow up through fiscal ROSCs which provide a stronger focus on key structural and management issues; (ii) where fiscal ROSCs have identified weaknesses of significance to programs, steps for improvement have been incorporated in program conditionality; and (iii) Fund TA missions have in some cases followed up on ROSC recommendations to help the authorities on technical issues. ROSCs are voluntary, but staff continues to encourage member countries to participate in this initiative. The current work program projects an average of 12–15 fiscal ROSCs per year.

Data ROSCs and the Data Quality Assessment Framework (DQAF)
There are some areas of overlap between the data and fiscal ROSC modules, particularly with regard to the Government Finance Statistics component of the data ROSCs. In efforts to enhance data quality in member countries, the Data Quality Assessment Framework (DQAF) has been developed as a systematic tool to assess data quality. Data ROSCs provide an assessment of the quality of selected macroeconomic datasets based on the DQAF. In addition, the TA activities of STA reflect an increased emphasis on improving data quality. In this regard, TA is prioritized through the ROSC process. On average, 15 data ROSCs are conducted annually.

[1] *Assessing and Promoting Fiscal Transparency—A Report on Progress* (3/6/03).

international audit firms, have also been found to be inadequate in some cases. In such instances, proposed measures included the addition of more experienced or international personnel to the audit team coupled with peer reviews (by an international office of the same firm).

28. **Central banks face obstacles in the implementation of safeguards recommendations in three areas**: (i) measures that required changes to regulations or national law; (ii) capacity constraints; and (iii) political sensitivities. Staff has dealt with these issues in a variety of ways based on the circumstances in individual cases.

- First, legislative difficulties usually stem from recommendations concerning the operational independence of the central bank. Further, recommendations in the legal structure and independence area represent a small fraction of total recommendations (about seven percent). Staff has limited the remedial measures requiring legislative amendments to operational aspects such as the clarification of provisions on credit to government, or the appointment and removal terms for board members and the head of the central bank.

- Second, capacity constraints have been noted by central banks especially with regard to the lack of available expertise within the central bank to implement IFRS and also the cost of conducting proper audits. Staff has taken these concerns into consideration, where possible, by (i) proposing realistic deadlines for major initiatives such as IFRS implementation; (ii) prioritizing technical assistance requests related to safeguards recommendations; and (iii) facilitating donor funding for improvements (e.g., for an ISA external audit of one central bank).

- Third, in the few instances where political sensitivities were encountered, the difficulties led to delays in the implementation of safeguards recommendations. Examples of such sensitivities are the recommendation to conduct a special audit related to the misreporting case in The Gambia, and a recommendation for a joint-audit of the central bank involving an independent audit firm with ISA expertise in another country. The key consideration in exploring possible alternative solutions in such cases is the risk posed to Fund resources. A special audit in The Gambia is now underway, while an interim solution for a targeted review of NIR and reserve money was explored with country authorities in the other case. Close collaboration among staff, particularly with Fund country teams, is necessary in such instances.

29. **At the same time, it should be noted that flexibility can only be exercised to the extent that it does not undermine the essence of the safeguards policy**. For example, in the case of Vietnam, the safeguards assessment of the State Bank of Vietnam (SBV) identified weaknesses in several areas, including the external audit mechanism and the financial reporting framework. While considerable efforts were made to reach agreement to enable the SBV to meet the policy's requirements with regard to, *inter alia*, the external audit arrangements, the measures proposed by staff were considered by the authorities to be incompatible with the legal framework (in particular, the state secrecy laws) in Vietnam. The review under the program could not be concluded in 2002, given the authorities' reluctance to comply with the safeguards policy's requirements.[12]

[12] See Box 3 in the August 2003 Article IV staff report and paragraph 19 in the November 2004 staff paper on the ex post assessment of longer-term program engagement for Vietnam for further background information on the safeguards issues.

30. **Under the policy, safeguards assessments should be completed no later than the first review of the member's Fund-supported program**. This operational deadline is important to ensure that the primary objectives of the policy are upheld. In most cases, this requirement was met and, in fact, in some instances assessments were completed ahead of the approval of the arrangement. The first review completion deadline was not met in nine cases.[13] In cases where the assessment was completed after approval of the arrangement, the assessment included a review of the quantitative performance criteria or the TMU agreed under the program. On balance, staff considers the first review to be an appropriate formal deadline.

31. **Deadlines for implementation of safeguards recommendations are determined on a case-by-case basis**. During the review of the safeguards policy in 2002, several Directors suggested that key weaknesses should be addressed prior to the second review of the Fund-supported program. In general, the time frame for implementation depends on the nature of the vulnerability identified; some vulnerabilities such as a deficient external audit mechanism can be corrected in a relatively short time, while, say, adoption of an internationally recognized accounting framework, is a more complex process. Where a long implementation period was expected, staff recommended supplementary, and compensating, remedial actions that could be implemented in relatively quicker time, such as (i) formal reconciliation of account balances with key monetary data reported to the Fund at specified dates; and (ii) use of IFRS-compliant templates, developed with the assistance of external auditors, for the preparation of financial statements during the interim period to full adoption of IFRS as the permanent accounting framework.

32. **Confidentiality**. Currently, safeguards assessment reports are confidential documents transmitted to the central bank and the relevant Fund Executive Director. The Executive Board receives (i) a summary of the findings and recommendations of a safeguards assessment in staff reports, and (ii) periodic update reports on safeguards assessments in general. On several occasions, staff has been approached by staff from other institutions (e.g., the World Bank and ECB) for information on particular aspects of the safeguards assessments for certain central banks. While reports should remain confidential, staff proposes that, with the authorities' consent, staff be allowed to share these reports with other international organizations such as the World Bank, Asian Development Bank (ADB), African Development Bank (AfDB) and European Central Bank (ECB) staff. Such modalities mirror the recent guidance on technical assistance reports where reports can be transmitted to international agencies with the member's consent and on the understanding

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[13] The majority of these cases occurred in the early stages of implementation of the policy: two in 2001 (Ethiopia and Georgia); four in 2002 (Azerbaijan, Lao P.D.R., Sierra Leone, and Uruguay); two in 2003 (Nicaragua and Tajikistan); and one in 2004 (Argentina). Completion of assessments takes an average of nine months, but has ranged from three months to 22 months. Factors that contribute to the long cycles are: (i) delays in obtaining the initial documentation; (ii) extensive translations of documents in many cases; and (iii) the need for clarification of certain issues, particularly in the initial stages of the assessments.

that the reports will be kept confidential.[14] Staff envisages reciprocity through a sharing of information in similar areas, particularly with the World Bank, which has initiated operations similar to safeguards assessments.

C. Resources and Budgetary Costs

33. **The safeguards operations absorbed 15 full-time staff equivalents (FTEs) in FY2005**. A highly streamlined operation was possible through the use of an efficient methodology, specialized staff, collaboration with central banks, and the effective use of IT to store and manage a large amount of data provided by central banks. As noted in the previous review, the safeguards operations have been completely financed through redeployment of existing staff positions within FIN—a combination of intensified development of in-house expertise and external recruitment—and with the assistance of specialized staff in other departments (OIA and MFD) in the initial phases of the policy through to mid-2004.

34. **Staff believes that resources are adequate to accommodate the demands going forward**. These are discussed further in Section IV. In FY2005, the safeguards assessment budget at 15 FTEs and projected travel expenses of about US$600,000 approximates US$2.9 million, in the overall Fund administrative budget of US$905.1 million.

IV. The Way Forward

35. **The expected shift from new assessments to *update* assessments and the monitoring of proposed remedies under previous assessments did not fully materialize in 2003, as had been anticipated in the 2002 review**. The delay was a result of the larger than expected number of new Fund arrangements approved between 2002 and 2004: there were 22 new arrangements in FY2003 and 14 in FY2004. New assessments therefore continued to account for a significant proportion of the workload through FY2004. However, safeguards operations have now reached a stage where the focus is shifting to update assessments of central banks that were previously subject to a safeguards assessment and monitoring of safeguards recommendations from previously completed assessments.

36. **Three important factors point toward a continued need for a consistent application of safeguards in the future**.

- First, the assessments are only a "snapshot" of the safeguards framework at central banks. Much like the necessity for *annual* external audits, safeguards assessments should be conducted on a periodic basis, because the institutional internal control environment is dynamic and, therefore, subject to change over time. Internal controls in an institution are established through policies and procedures that are effected by several parties, such as senior management, the board of directors, and other

[14] *Review of Technical Assistance Policy and Experience*, (06/13/02).

personnel. Not only are the policies and procedures subject to periodic change, but adherence to the policies and procedures can also be influenced by a number of other factors including personnel and management.

- Second, vigilance is warranted to protect the Fund's resources and manage its reputational risk. It is important to ensure that if central banks introduce major changes, for example, in their accounting or auditing practices, the Fund should be in a position to monitor the changes.

- Third, there may be new arrangements for countries whose central banks have not yet had a safeguards assessment.

37. **The nature of future safeguards assessments will continue to evolve because prior assessments and the resultant central bank improvements should enable tightly focused and targeted follow-up assessments**. In particular, greater reliance will be placed on controls that have been put in place as a result of previous safeguards assessments; for example, high-quality external audits should facilitate a more efficient identification of internal control issues at a central bank. Therefore, the intensity of safeguards will evolve to a more compliance-oriented assessment. There should be some decline in the resources allocated to safeguards assessments over time given the decrease in first-time assessments, which will be only partly offset by the on-going monitoring. The monitoring should remain in place for as long as Fund credit remains outstanding, as agreed by the Board in the 2002 review. Some operational aspects of the safeguards policy are discussed in the following paragraphs.

A. Types of Assessments

38. **Staff envisages three distinct types of safeguards assessments**: (i) new assessments, (ii) update assessments, and (iii) monitoring assessments.

39. **New assessments**. Full safeguards assessments will be conducted if a new Fund arrangement is requested by a country not previously subject to an assessment. New assessments would typically involve an on-site assessment, after an off-site evaluation of the initial documentation requested from the central bank.

40. **Update assessments**. This type of assessment should constitute the majority of future safeguards work. Update assessments are conducted when a member country whose central bank was subject to a previous safeguards assessment requests a subsequent successor or new Fund arrangement. Update assessments take into account the previous safeguards assessment, the monitoring of implementation of recommendations, and new information from the central bank. Depending on the perceived risk, update assessments may either be conducted off-site or on-site.

41. **Monitoring assessments**. Monitoring will normally be conducted from headquarters, unless risk factors are such that an on-site visit is considered necessary. Such cases may arise where (i) there has been a disruption in safeguards monitoring, e.g., significant delays in

implementation of priority recommendations, or a program has gone off-track; (ii) there is a need to assess *de novo* central bank safeguards issues, because of a breakdown in controls, e.g., the external auditor raises critical concerns on the internal controls, or flags issues in the audit opinion; or (iii) relevant safeguards issues are identified during Fund surveillance and further follow-up by a safeguards team is considered necessary.

B. Future Application of the Policy in EPCA Cases

42. **In March 2004 the Executive Board discussed the extension of the safeguards policy to EPCA cases**.[15] It is difficult to justify continued exclusion of EPCA from safeguards assessments when the risks to Fund resources are probably higher than in other cases.[16] On the other hand, full assessments cannot always be undertaken at an early stage, due to the absence of a fully functional central bank, a hallmark of post-conflict cases in the early stages of reconstruction. In such cases, practical difficulties are encountered if a full safeguards assessment is undertaken, because there would simply be no capacity to implement a full range of safeguards recommendations.[17] A full assessment may, therefore, not be meaningful until some fundamental controls are in place. Instead, a targeted assessment may be more appropriate and useful to help monitor progress toward developing the necessary systems that would need to be in place once the member moves to an upper-credit tranche or PRGF arrangement.

43. **Staff proposes that the policy be extended to include EPCA cases**. The modalities for the safeguards assessments would be determined on a case-by-case basis, taking into account the degree of re-establishment of functioning monetary and financial systems. Such an approach, with regard to the timing and procedures for the safeguards assessment, would be based on the existence, and the level of institutional and administrative capacity, of the central bank at the time of access to EPCA.[18] In order to accommodate such instances, key guidelines that would influence management in implementing a case-by-case approach could be as follows:

- If there is no functioning central bank, the safeguards assessment would be delayed until the reconstruction process establishes a sufficient degree of functional capability for the central bank to enable a meaningful assessment, since the safeguards framework presumes the existence of a central bank.

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[15] In the context of discussions on the *Fund's Support of Low-Income Countries—Consideration on Instruments and Financing* (2/24/04).

[16] In the face of such risks, in the past it has proven useful to make IMF disbursements to a member country's SDR account, such as in the recent case of Iraq.

[17] The security situation may be an additional hindrance in some cases.

[18] Staff's experience with post-conflict situations indicates that the process to restore properly functioning monetary and financial systems in post-conflict countries can be lengthy and the early stages are often characterized by an absence of a functioning central bank. See *MFD Technical Assistance to Recent Post-Conflict Countries* (12/14/04).

- If a central bank exists, the degree of its functional capability would be evaluated in order to determine whether a full safeguards assessment is feasible. If a full safeguards assessment were deemed infeasible, a *targeted* safeguards assessment aimed at basic control functions will be undertaken.[19]

- Where a functioning central bank exists, as was the case for certain post-conflict countries such as Rwanda and the Democratic Republic of Congo, a full safeguards assessment will be conducted.[20]

44. **Staff does not propose extension of the safeguards policy to emergency assistance for natural disasters cases or outright purchases under the Compensatory Financing Facility (CFF)**. Emergency assistance for natural disasters is available where a member country cannot meet its immediate financing needs arising from a natural disaster (e.g., earthquakes, floods, or hurricanes) without serious depletion of its foreign reserves, while the CFF was established to ensure *timely* external financing for member countries experiencing balance of payment difficulties resulting from a temporary decline in export earnings. In both cases, (i) Fund lending is required under very urgent circumstances which would not present realistic conditions for the conduct of a full safeguards assessment, and (ii) unlike EPCA cases, there is no presumption that member countries would subsequently move to an arrangement.

C. Periodicity of Safeguards Update Reports to the Board

45. **Currently, semi-annual update papers are presented to the Board on safeguards assessment activities**. These reports provide the Board with a summary of assessments conducted to date, including the number of safeguards recommendations made and their implementation rates. This process continues to be a useful mode of communication of safeguards issues to the Board. Staff proposes that update papers should be prepared on an annual basis going forward. In past years, about twenty safeguards assessments were completed annually, but since fewer *new* assessments are expected going forward, it may be more meaningful to provide an annual rather than a semi-annual update. Periodic reviews of the safeguards policy are expected to be performed every three years.

D. Independent Panel's Observations

46. **The panel's report concluded that the safeguards policy has been a success and the safeguards process has been relatively efficient**. The panel also made observations in two areas: communications and monitoring procedures. The panel observed the need to strengthen communication in three main areas: (i) more regular contact between Fund staff

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[19] A similar approach was followed with respect to the safeguards assessment of the Banque de la République du Burundi, in the context of the 2004 PRGF arrangement with Burundi.

[20] A full safeguards assessment is currently underway for Haiti, which made a purchase under EPCA in January 2005. Haiti requested the assessment in anticipation of a future PRGF arrangement.

and the central bank staff on safeguards issues; (ii) enhancement of safeguards information on the Fund's web-site; and (iii) possible coordination of regional and global forums on safeguards issues. Further, the panel noted that, going forward, the modalities for monitoring safeguards at central banks previously subject to an assessment should include on-site visits to central banks when deemed necessary, and that off-site monitoring should include updates on pertinent developments in a central bank's ELRIC areas, in addition to the current monitoring of the implementation of safeguards assessment recommendations. Staff agrees with the panel's recommendations and is taking steps to operationalize them.

V. Issues for Board Discussion

47. Directors may wish to comment on the following issues:

- Section II of the report discusses the results of the safeguards policy to date. Staff would welcome Directors' views on whether the policy achieved its desired objectives and whether any changes should be made.

- Section V discusses staff's views on the way forward for the safeguards policy. Staff would welcome Directors' views on:

    - whether the modalities for the three types of assessment going forward and the proposed approach for EPCA cases are broadly appropriate; and

    - whether (i) the periodicity of update Board papers on safeguards assessments could be changed from a semi-annual to an annual basis, and (ii) the policy should continue to be periodically reviewed, say, every three years.

- Staff discussed the issues relating to confidentiality of safeguards reports under the policy. Staff would welcome Directors' views on whether the safeguards assessment reports could be shared with staff from other IFIs (World Bank, ADB, AfDB, ECB), with the authorities' consent and in accordance with guidelines similar to those for technical assistance reports.

Completed Safeguards Assessments
(as of March 1, 2005)

Transitional Procedures - Report on the External Audit Mechanism	**Full Safeguards Assessments[1,2,3]**				
(27)	**Completed in 2001 (16)**	**Completed in 2002 (22)**	**Completed in 2003 (24)**	**Completed in 2004 (19)**	**Completed in 2005[4] (3)**
Argentina	Albania	Albania	Bolivia	Argentina	Bangladesh
Bolivia	BEAC	Argentina	Colombia	BEAC	Bosnia and Herzegovina
Bosnia/Herzegovina	Ethiopia	Armenia	Congo, D.R.	Belarus	Croatia
Bulgaria	Kenya	Azerbaijan	Croatia	Bolivia	
Cambodia	Latvia	Bangladesh	Dominican Republic	Brazil	
Colombia	Lesotho	BCEAO	ECCB	Bulgaria	
Djibouti	Lithuania	Bosnia and Herzegovina	Ecuador	Burundi	
Estonia	Madagascar	Brazil	Ghana	Cambodia	
Ghana	Malawi	Brazil	Guyana	Gambia	
Guyana	Nicaragua	Bulgaria	Jordan	Georgia	
Honduras	Nigeria	Cape Verde	Kenya	Honduras	
Indonesia	Pakistan	El Salvador	Lao P.D.R.	Mauritania	
Jordan	Peru	Georgia	Lesotho	Mozambique	
Latvia	Serbia and Montenegro	Guatemala	Macedonia (FYR)	Nepal	
Lithuania	Sri Lanka	Guinea	Malawi	Peru	
Mauritania	Tajikistan	Kyrgyz Republic	Mongolia	Romania	
Mozambique		Moldova	Nicaragua	São Tomé & Príncipe	
Panama		Mongolia	Paraguay	Ukraine	
Papua New Guinea		Nepal	Rwanda	Zambia	
Romania		Romania	Sri Lanka		
São Tomé & Príncipe		Sierra Leone	Tajikistan		
Tanzania		Turkey	Tanzania		
Turkey			Uganda		
Ukraine			Uruguay		
Uruguay					
Yemen					
Zambia					

[1] Vietnam is excluded because the arrangement expired before the assessment was completed.
[2] In light of the constrained administrative and technical capacity in Burundi, a targeted assessment focusing on the external audit, financial reporting, and internal controls was conducted.
[3] 19 central banks have undergone two full safeguards assessments: Albania, Argentina, Bangladesh, BEAC, Bolivia, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Kenya, Lesotho, Malawi, Mongolia, Nepal, Nicaragua, Peru, Romania, Sri Lanka, and Tajikistan; and one central bank, Brazil, has undergone three full safeguards assessments. Subsequent full assessments at central banks constitute *update* assessments as described in paragraph 40 of the paper.
[4] Data as of March 1, 2005. There was one other assessment, Guatemala, that was in progress and near completion.